



GOVERNOR ARNOLD SCHWARZENEGGER

April 28, 2004

The Honorable Michael R. Peevey
President
Public Utilities Commission
505 Van Ness Avenue
San Francisco, CA 94102

Dear President Peevey,

Thank you for forwarding to my office your March 15, 2004 letter to the Legislature accompanying the staff report on a core/non-core electricity market structure. I was very encouraged by your stated commitment to work toward an electric market structure that encourages healthy wholesale and retail competition which translates to system reliability and lower bills for both residential and business customers.

I also want to take this opportunity to urge the Public Utilities Commission to expeditiously implement AB 57. AB 57 corrected one of the key flaws in California's electricity restructuring effort: the inability of investor-owned utilities to develop diversified resource portfolios and enter into long-term contracts without the risk of after-the-fact reasonableness reviews by the Commission. AB 57 requires the utilities to devise a procurement plan that includes a competitive procurement process, while reaffirming the utilities' obligation to integrate cost-effective energy efficiency opportunities fully into those plans and to acquire more renewable energy generation. The Commission is required to set "upfront standards and criteria by which the acceptability and eligibility for rate recovery of a proposed procurement transaction will be known by the electrical corporation prior to execution of the transaction. This shall include an expedited approval process for the Commission's review of proposed contracts and subsequent approval or rejection thereof."¹

The importance of these two provisions cannot be understated. A transparent, competitive procurement process is necessary to ensure that the utilities obtain the least cost alternatives to meet their demand. It should be based on sound economic principles which avoid the creation of future stranded costs. Upfront rate recovery standards give

¹ AB 57 - Public Utilities Code Sec. 454.5 (b) (7)

the utilities the assurance that they can recover the costs of prudent long-term contracts through rates, which did not exist during the electricity crisis. Long-term contracts, procured by the utilities, are the means by which California will attract necessary private investment and build the resource portfolios needed to ensure reliability and keep prices low in the future.

In implementing AB 57, I encourage the Commission to adopt the recommendations of the Energy Action Plan that calls for utilities to institute a loading order when planning for their power needs. The loading order prioritizes energy efficiency, conservation, demand response/real-time pricing and renewable energy over new fossil fuel powered generation. I support this loading order and encourage aggressive implementation of these policies, to the full extent authorized by law.

I also urge the Commission to revisit its recent decision on resource adequacy. I commend the Commission for requiring the utilities to procure power reserves of 15 percent. A strong reserve margin will prevent future electricity shortages and blackouts. However, I am concerned that the Commission's phase-in date of 2008 is too slow. The California Independent System Operator's (CAISO) recent Summer Assessment concludes that strong economic growth and low hydro conditions could cause electricity shortages as early as this summer². The Commission should accelerate its resource adequacy requirement and work closely with the CAISO to implement the resource adequacy standards. The Commission should also expand investment in cost-effective energy efficiency and demand response programs that will help reduce overall and peak electricity usage.

Currently, wholesale electricity prices are relatively low. Now is the time for utilities to lock in these low prices through long-term contracts. California still relies on several old, inefficient power plants to meet its summer peak demand. However, many of these old plants are overdue for retirement, given their high operating costs and poor environmental performance. To compensate for these plant retirements and to plan for the inevitable return of strong economic growth, California cannot afford to delay the construction of new power plants. Full implementation of AB 57 is needed to remove the regulatory uncertainties that have paralyzed crucial investment in California's electricity infrastructure. I urge the Commission to complete this task as quickly as possible.

Once again, I was encouraged by your letter of March 15th to the Legislature. I support your effort to create retail electricity markets that allow core customers to continue to receive regulated electricity service, while allowing large customers to shop for competitive wholesale power prices. Your April 8, 2004 discussion draft on core/non-core electric market structure was also very helpful in identifying the key issues that policymakers must address as they consider reinstituting competitive retail markets. Of

² CAISO Summer Assessment; April 16, 2004;
<http://www.caiso.com/docs/09003a6080/2f/ca/09003a60802fca50.pdf>

The Honorable Michael R. Peevey

April 28, 2004

Page 3 of 3

course, customers that choose to bypass utility service by taking advantage of the opportunity for direct access should bear full responsibility for their management of electricity price and availability risks. And utilities should be responsible for energy procurement and risk management for residential and smaller commercial customers, as well as for the larger customers that choose to remain with the utility as their supplier.

As Governor, I have pledged to improve California's business climate and create new jobs. Countless businesses have told me that one of the greatest barriers to doing business in California is high energy prices. By fostering competitive wholesale and retail electricity markets that are properly monitored by regulators, California can begin to lower electricity bills and once again become the job creation machine it once was. I look forward to working with you and your fellow Commissioners to achieve this goal.

Sincerely,

A handwritten signature in black ink, appearing to read "Arnold Schwarzenegger", with a stylized, cursive script.

Arnold Schwarzenegger

/gmr

cc: Commissioners, Public Utilities Commission
The Honorable Geoffrey F. Brown
The Honorable Susan P. Kennedy
The Honorable Loretta M. Lynch
The Honorable Carl Wood